IN THE

Supreme Court of the United States

October Term, 1940.

No. 491.

BASTIAN BROS. CO., *Petitioner,*

v.

GEORGE T. McGOWAN, Collector of Internal Revenue for the 28th Collection District of New York, *Respondent.*

On Writ of Certiorari to the United States Circuit Court of Appeals for the Second Circuit.

BRIEF FOR PETITIONER, BASTIAN BROS. CO.

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Opinions Below.

District Court—Western District of New York—(R. 61-64) 32 Fed. Supp. 93.

Second Circuit Court of Appeals (R. 67-68)—113 Fed. (2) 489.

Jurisdiction.

Petition for writ of certiorari was filed October 8, 1940. If granted jurisdiction will be based on Sec. 240 (a), Judicial Code, as amended by Act of February 13, 1925.

Statement.

(1) Bastian Bros. Co. was incorporated October 18, 1906. Its certificate recites that it is formed "pursuant to the provisions of the Business Corporations Law of the State of New York" (R. 9).

(2) Section 58 of the Stock Corporation Law (derived from the Business Corporations Law and in force at all times relating to this action) provides (R. 37).

> "No stock corporation shall declare or pay any dividend which shall impair its capital or capital stock, nor while its capital or capital stock is impaired, nor shall any such corporation declare or pay any dividend or make any distribution of assets to any of its stockholders, whether upon a reduction of the number of its shares or of its capital or capital stock unless the value of its assets remaining after the payment of such dividend, or after such distribution of assets, as the case may be, shall be at least equal to the aggregate amount of its debts and liabilities including capital or capital stock as the case may be."

(3) Section 664 of the Penal Law of the State of New York provides (R. 38):

> "§664. Misconduct of Officers and Directors of Stock Corporations.
>
> "A director of a stock corporation, who concurs in any vote or act of the directors of such corporation, or any of them, by which it is intended:
>
> "1: To make a dividend, except from surplus, and in the cases and manner allowed by law; or
>
> 2: To divide, withdraw, or in any manner to pay to the stockholders, or any of them, any part of the capital stock of the corporation; or to reduce such capital stock without the consent of the legislature; or * * *
>
> Is guilty of a misdemeanor."

(4) On June 12, 1912 the corporation executed and filed a certificate of increase of capital stock. (R. 13) Similar certificates of increase were executed by the corporation and filed February 20, 1917 (R. 16), on September 16, 1919 (R. 19) and on March 11, 1920 (R. 23).

(5) Certificates of increase of the number of Directors were executed by the corporation and filed March 11, 1920 (R. 27) and February 4, 1931 (R. 29).

(6) Bastian Bros. Co. had a net income for 1936 of $28,917.87 (R. 3, f. 13) and for 1937 of $105,321.16 (R. 6, f. 29).

(7) During 1930, 1931, 1932 and 1933 Bastian Bros. Co. had each year lost money on its operations, so that during 1936 and 1937 there existed a substantial impairment of capital arising solely from these operating losses (R. 4, f. 16; R. 7, f. 32).

(8) On its 1936 income Bastian Bros. Co. paid as a surtax upon undistributed profits $4,741.67 (R. 3, f. 14). On its 1937 income it paid as such surtax $18,590.00 (R. 6, f. 30).

(9) During 1936 and 1937, because of the impairment of capital existing throughout both years, Bastian Bros. Co. could not, without violating the Statutes of New York State, under which the corporation was organized and is existing, declare and pay any dividends. Any director voting for the declaration of a dividend would have violated the Penal Laws of the State of New York.

(10) On October 28, 1938, Bastian Bros. Co. filed a claim for refund of $4,471.67, the amount which it had paid as the surtax on undistributed profits for 1936 (R. 38-39). On December 27, 1938, Bastian Bros. Co. filed a claim for refund of $18,590.00, the amount which it has paid as a surtax on undistributed profits for 1937 (R. 53-54).

(11) The claims for refund were neither allowed nor rejected and suit for refund was commenced by the filing of a complaint and issuance of a summons on September 19, 1939. A motion to dismiss the complaint for failure to state a cause of action was granted and judgment entered March 15, 1940. Appeal to the United States Circuit Court of Appeals for the Second Circuit was taken and on July 29, 1940 the judgment of the District Court was affirmed.

(12) The District Court held that this case was controlled by *Crane-Johnson Co.* v. *Commissioner,* 105 Fed. (2d) 740 (CCA-8th) which was decided against the taxpayer (R. 63). The Second Circuit affirmed upon the opinion of the District Court and stated per curiam that both the text and legislative history of § 26(c)(1) supported such decision. (R. 67-68)

Question.

Is a certificate of incorporation executed "pursuant to the Business Corporation Law of the State of New York" on October 18, 1906, "a written contract executed by the corporation prior to May 1, 1936?"

Is an amendment to a certificate of incorporation executed on June 19, 1912 "a written contract executed by the corporation prior to May 1, 1936?"

Argument.

Petitioner wishes to adopt the reasoning set forth in the briefs filed by taxpayers in the *Crane-Johnson* Case (on Writ of Certiorari to 8th Circuit) and in the *Northwest Steel Rolling Mills* case (on Writ of Certiorari to 9th Circuit).

Petitioner desires to briefly discuss two points:

(1) The meaning of the words "a written contract executed by the corporation."

(2) The legislative history of the Undistributed Profits Tax.

I.

The Eighth Circuit Court of Appeals in the *Crane-Johnson* case, speaking of the charter of a corporation said (105 Fed. (2d) 740):

> "Such contract as arises from the organization of a corporation under state laws is implied rather than a voluntary written agreement entered into by the corporation."

The District Court in the *Bastian* Case, whose reasoning was adopted by the Second Circuit, 32 Fed. Supp. 93, said:

> "The obligation is implied between a corporation, a creature of the State, and the State which created it, that the corporation will abide by the laws of the State."

The language of Sec. 26(c)(1), the statute to be construed, does not talk of express contract, implied contract, or voluntary contract. It says "a written contract".

The contract between State and Corporation is a written contract. All of it is written. There is (1) a written charter and (2) a written statute. Together they make a written contract.

Section 26(c)(1) does say there must be a provision expressly dealing with the payment of dividends. Section 58 of the New York Stock Corporation Law expressly deals with the payment of dividends.

Amendments to the charter are likewise written contracts. There is nothing oral about them either. They are a corporate act and are executed by the corporation.

The word "execute" is a word of several meanings. The respondent's contention is that it means "signed", and that because the corporation did not "sign" the original charter, the charter is not a contract executed by the corporation.

It is submitted that the words "executed by the corporation" should be given their fair and natural meaning.

Webster's Collegiate Dictionary (Fifth Edition 1939) defines "execute" as follows:

> "1. To follow out or through to the end, as a purpose; to complete; effect; perform.
> 2. To give effect to; to do what is provided or required by, as a writ.
> 3. To put to death in conformity to a legal sentence.
> 4. To produce by art in accordance with a design, plan, or the like; as, a statue executed in bronze; to perform, as a piece of music, either on an instrument or with the voice.
> 5. To perform what is required to give validity to (a deed, will, etc.) as by signing, sealing, delivering.
> *Synonyms*—"Accomplish, manage conduct, direct.—Execute, administer, enforce. To *execute* is to carry out or into effect; to *administer,* to manage or direct the process of execution; to *enforce,* to bring about or compel the execution of something by force or penalty, as the laws or a rule."

Signing a certificate by incorporators is but one step in the execution of the contract. When the certificate is filed, organization fees paid, and other statutory requirements met, then there is a "written contract executed by the corporation".

In other words there has been performed what is required to give validity to the instrument as a written contract. A contract, made up of (1) a *written* certificate of incorporation and (2) *written* statutory provisions of state law expressly dealing with dividends has been then executed by the corporation.

In the Dartmouth College case (*Dartmouth College* v. *Woodward,* 4 Wheaton 518) argument was made that the charter was not a contract, because the corporation was not in existence as a contracting party. Answering that argument Mr. Justice Story said (Pages 690-692):

> "And here we might pause; but there is yet remaining another view of the subject, which cannot consistently be passed over without notice. It seems to be assumed by the argument of the defendant's counsel,

that there is no contract whatsoever, in virtue of the charter, between the crown and the corporation itself. But it deserves consideration, whether this assumption can be sustained upon a solid foundation.

"If this had been a new charter granted to an existing corporation, or a grant of lands to an existing corporation, there could not have been a doubt that the grant would have been an executed contract with the corporation; as much so, as if it had been to any private person. But it is supposed, that as this corporation was not then in existence, but was created and its franchises bestowed, uno flatu, the charter cannot be construed a contract, because there was no person in rerum natura, with whom it might be made. Is this, however, a just and legal view of the subject?

"If the corporation had no existence so as to become a contracting party, neither had it for the purpose of receiving a grant of the franchises. The truth is, that there may be a priority of operation of things in the same grant; and the law distinguishes and gives such priority wherever it is necessary to effectuate the objects of the grant. From the nature of things, the artificial person called a corporation must be created before it can be capable of taking anything.

"When, therefore, a charter is granted, and it brings the corporation into existence without any act of the natural persons who compose it, and give such corporation any privileges, franchises, or property, the law deems the corporation to be first brought into existence, and then clothes it with the granted liberties and property. When, in the other hand, the corporation is to be brought into existence by some future acts of the corporators, the franchises remain in abeyance, until such acts are done, and when the corporation is brought into life the franchises instantaneously attach to it. There may be, in intendment of law, a priority of time, even in an instant, for this purpose.

"And if the corporation have an existence before the grant of its other franchises attaches, what more difficulty is there in deeming the grant of these franchises a contract with it, than if granted by another instrument at a subsequent period? It behooves those also, who hold that a grant to a corporation, not then in existence, is incapable of being deemed a contract on

> that account, to consider whether they do not at the same time establish that the grant itself is nullity for precisely the same reason. Yet such a doctrine would strike us all as pregnant with absurdity, since it would prove that an act of incorporation could never confer any authorities, or rights, or property, on the corporation it created. *It may be admitted that two parties are necessary to form a perfect contract, but it is denied that it is necessary that the assent of both parties must be at the same time.*" (Italics ours)

Mr. Justice Story then cites several specific instances to support his reasoning and goes on to say (page 693):

> "We must admit that there may be future springing contracts in respect to persons not now in esse, or we shall involve ourselves in inextricable difficulties. And if there may be in respect to natural persons, why not also in respect to artificial persons, created by the law, for the very purpose of being clothed with corporate powers? I am unable to distinguish between the case of a grant of land or of franchises to an existing corporation, and a like grant to a corporation brought into life for the very purpose of receiving the grant. *As soon as it is in esse, and the franchises and property become vested and executed in it, the grant is just as much an executed contract as if its prior existence had been established for a century.*" (Italics ours)

Somewhat akin to the question now before this Court is the obligation of a corporation upon contracts made for it by its promoters or incorporators.

In *Rogers* v. *New York & Texas Land Co.*, 134 N. Y. 197, the bondholders of a railroad formed a new corporation which was to take title to certain lands. Speaking of the nature of the contract, the New York Court of Appeals, through Mr. Justice Vann said (page 211):

> "The bondholders were the promoters of the land company. Being about to form a corporation for an authorized purpose, they made an agreement upon the subject in which they provided for benefits to be conferred upon it and burdens to be assumed by it after

its organization. While it could have refused, when it came into existence, to accept the one or to be bound by the other, it could not accept the advantages and then refuse to assume the obligations. By accepting title to the land it adopted and ratified the agreement entered into by all its stockholders, and thereby voluntarily made itself a party thereto and became bound thereby.

The adoption by the land company of the contract between the bondholders was a reasonable means of carrying into effect its authorized objects, and, after knowingly receiving the benefit of the arrangement, it cannot be permitted to deny that it agreed to assume the corresponding burdens. (Morawetz on Corporations, § 548, and cases cited.) There can be little doubt as to the intention of the promoters that the corporation, when formed, was not only to become a party to the agreement, but was to be the *chief actor* to carry it into effect. They created it exclusively as an *executive agent* to effect their purposes, and when that purpose is completely accomplished by the sale of all the land the proper applications of the proceeds, the object of the corporation will have been fully attained." (Italics ours.)

When we speak of a contract of the promoters of a corporation and say that the corporation is "the chief actor to carry it into effect" we mean that it is the corporation and not the individuals who *execute* the contract.

When we say of a contract initiated by promoters, that the corporation is "exclusively the executive agent to effect their purpose" we mean that the contract is one *executed* by the corporation.

When we speak of a charter as a written contract executed by the corporation, we mean that the corporation is the real party to that contract, the one to be bound and to carry it out, and not the individuals who formed the corporation.

II.

Legislative history of the Section 26 (c)(1) was given as one of the main reasons for affirmance by the Second Circuit Court of Appeals in this case (R. 68):

> "Both the text and legislative history of the section support the decision of the district judge and we are content to affirm the judgment upon his opinion."

It is submitted that an analysis of legislative history does not show an intent of Congress to exclude deficit corporations from the benefit of credit Section 26 (c)(1). It may be that such history shows no affirmative intent to include them, but no adverse inference should be drawn, as it has been.

When the *Crane-Johnson* case was before the Board of Tax Appeals, the Board assumed that Section 14 of the original House Bill, subsequently eliminated, was intended to afford relief to corporations which *could not* legally pay dividends, because of deficits. The Board reasoned that the elimination of Section 14 in the final bill therefore indicated an intent to exclude deficit corporations from the benefit of Credit Section 26 (c)(1). This argument was advanced by respondent before the Second Circuit and was apparently adopted by the latter.

A study of legislative history shows, however, that Section 14 of the original House Bill was intended to afford relief to corporations which *could* legally pay dividends, but which nevertheless would have received no credit, because of the then existing definition of "dividend."

The inequity which Section 14 was thus intended to remedy was later cured by an amendment to Section 115 (a) defining dividends. The elimination of Section 14 of the original bill should not therefore be taken to mean that some other Section, namely 26 (c)(1) is so narrow in scope as to afford no relief to corporations, which because of impairment of capital, *could not* legally pay dividends.

Before the Revenue Act of 1936 the term "dividend" was defined as follows—Section 115 (a) Revenue Act of 1934 (and corresponding sections of earlier acts):

> "Any distribution by a corporation to its shareholders whether in money or other property out of its earnings or profits accumulated after February 28, 1913."

To receive the "dividends paid credit" under Section 27 of the 1936 Act, the corporate distribution had to come out of earnings or profits accumulated after February 28, 1913. A distribution from any other source would not be a dividend and there would be no dividends paid credit.

The House Ways and Means Subcommittee Report (74th Congress, Second Session—March 26, 1936) discussing original Section 14 of the House Bill said:

> "It is recommended that relief be provided for the corporation which, while having an adjusted net income for the taxable year, lacks sufficient accumulated earnings and profits *as of the close of the taxable year* from which to distribute *taxable dividends* equal to the adjusted net income." (Italics ours.)

The Committee then mentions three examples where a corporation *could* pay dividends and yet would receive no credit or only partial credit:

> "(1) A corporation may have an adjusted net income of $100,000, but a deficit, carried over from prior years, of $150,000. Any distribution by the corporation could not be out of accumulated earnings and profits, would not be taxable as a dividend to the shareholders and hence under the rule previously recommended (see definition of 'undistributed net income' in recommendation No. II), would not be deductible by the corporation from adjusted net income in computing undistributed net income. Therefore, even if an amount equal to the adjusted net income were distributed, the tax on the corporation would be the same as if no distribution were made.
>
> "(2) A similar hardship would exist where the net adjusted income is $100,000, with a prior deficit of $60,000. Here the maximum taxable dividend would be $40,000, and $60,000 would, even if distributed, be taxable to the corporation as if not distributed.
>
> "(3) Even if no deficit exists, hardship may exist where the earned surplus at the beginning of the taxable year is not enough to meet a non deductible loss occurring during the year. Thus suppose the accumulated earnings and profits at the beginning of the year

are $1,000, the adjusted net income $100,000, but a capital net loss of $40,000 has been sustained. The earnings and profits for the year are only $60,000, making the total accumulated earnings and profits $61,000. Therefore, without relief the, the corporation must pay tax on $39,000 even if it distributes $100,000, an amount equal to the entire adjusted net income.

To remedy this situation the original House Bill proposed Section 14, reading:

"SEC. 14. ACCUMULATED EARNINGS AND PROFITS LESS THAN ADJUSTED NET INCOME.

(a) *General Rule.*—If the accumulated earnings and profits of the corporation as of the close of the taxable year (computed without diminution by reason of the distribution during the taxable year of earnings and profits, or by reason of the taxes imposed by this title for the taxable year) are less than the adjusted net income, the tax imposed by section 13 shall, in lieu of being computed under section 13, be computed by adding:

(1) A tax of 15 per centum of the excess of the adjusted net income over such accumulated earnings and profits; and

(2) A tax upon the remainder of the adjusted net income (less the tax under paragraph (1)) computed under section 13 as if the adjusted net income were equal to the amount of such remainder so reduced."

The discussion and examples above show that the inequity the House had in mind was where a corporation *could* legally pay dividends and yet not receive a credit. This inequity was quite different from one where a corporation *could not* legally pay a dividend because of impairment of capital.

The Senate Finance Committee Bill eliminated this Section 14. It changed the definition of "dividend" in former Sec. 115(a) and in so doing incorporated in substance the language of Section 14 of the House Bill.

Section 115(a) (after the Senate amendment and as contained in the final Act) reads:

> "SEC. 115. DISTRIBUTIONS BY CORPORATIONS.
>
> (a) *Definition of Dividend.*—The term "dividend" when used in this title (except in Section 203(a)(3) and Section 207(c)(1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

The addition of subparagraph (2) to above Section 115(a) therefore made unnecessary Section 14 of the House Bill.

Congress evidently recognized that because of diversity of laws in various states relating to dividends, a considerable number of corporations *could* declare dividends even though they had no accumulated earnings or profits. Obviously such corporations are not prohibited by contract with the State of their creation from declaring dividends. As to this type of corporation under the original House Bill, having no accumulated earnings or profits, they would have received a dividends paid credit, even though no dividend was actually declared.

When this question came before the Senate the above change in the definition of dividend was made, with this result: that to obtain the dividends paid credit the corporation *actually* had to declare a dividend.

Section 14 of the House Bill and final Section 115(a) of the Act dealt with corporations which *could* legally pay dividends. Section 15 of the House Bill which became Section 26(c)(1) of the final Act covered corporations which *could not* legally pay dividends.

The respondent has consistently argued that the elimination of original Section 14 indicated an intent to deny relief to corporations which *could not* legally pay dividends whereas the above history shows it applied to corporations which *could* legally pay a dividend, but would have received no credit under the former definition of dividend.

Section 26(c)(1) should therefore be construed without adverse inference being drawn from the elimination by the Senate of Section 14 of the House Bill.

Section 26(c)(1) is broad enough to give relief to a corporation prohibited by contract from paying a dividend, whether that contract be with State or individual.

The section should be construed in the light of the purpose for which the Undistributed Profits Tax was passed.

In his message to Congress on March 3, 1936, President Roosevelt said:

> "The accumulation of surplus in corporations controlled by taxpayers with large incomes is encouraged by the present freedom of undistributed corporate income from surtaxes. Since the stockholders are the beneficial owners of both distributed and undistributed corporate income, the aim as a matter of fundamental equity, should be to seek equality of tax burdens on all corporate income, whether distributed or withheld from the beneficial owners. As the law now stands, our corporate taxes dip too deeply into the shares of corporate earnings going to stockholders who need disbursement of dividends, while the shares of stockholders who can afford to leave earnings undistributed escape current surtaxes altogether."

The same purpose was in the mind of both House and Senate in framing the Revenue Act of 1936. *House Report #2475, 74th Congress, April 21, 1936,* after mentioning the avoidance of surtax by wealthy stockholders who allowed large corporate surpluses to accumulate said:

> "Corporations should not be permitted to withhold from the beneficial shareholders *unneeded* corporate

> income at the expense of the revenues of the United States and to the detriment of stockholders." (Italics ours.)

Both the majority Senate Finance Committee Report and in particular the minority Report of Senators Black and LaFollette, refer to the avoidance of surtax through the corporate medium as the evil to be remedied. Senator Black summed it up by saying:

> "By this simple device of retaining corporate profits *unnecessarily* there has evolved the most stupendous tax avoidance in our history." (Italics ours.)

Of course the purpose of the Revenue Act is to raise revenue, but the whole background of that portion of it known as the Undistributed Profits Tax, was to tax sources which had previously avoided taxation. It was never the intent to tax as undistributed profits, earnings which could not be distributed.

It is therefore respectfully submitted that in the light of the purpose of the Act and its legislative history, Section 26 (c)(1) should be given a liberal construction, a construction which does not penalize the corporation which could not distribute and yet is taxed for not distributing.

Respectfully submitted,

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In the Supreme Court of the United States

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BASTIAN BROS. CO., PETITIONER

v.

GEORGE T. MCGOWAN, COLLECTOR OF INTERNAL REVENUE FOR THE 28TH COLLECTION DISTRICT OF NEW YORK

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

MEMORANDUM FOR THE RESPONDENT

The question presented in this case is precisely the same as that presented in *Crane-Johnson Co.* v. *Commissioner,* No. 8, present Term, and in *Northwest Steel Rolling Mills, Inc.* v. *Commissioner,* No. 121, present Term. The *Crane-Johnson* and *Northwest Steel* cases were argued before this Court on October 23, 1940, and are now under submission. In these circumstances, we respectfully suggest that disposition of the petition for writ of certiorari in the present case should await

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decision in the *Crane-Johnson* and *Northwest Steel* cases.

Respectfully submitted,

FRANCIS BIDDLE,
Solicitor General.

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